

Office of the Legislative Auditor

State of Montana



Report to the Legislature

January 1993

Financial-Compliance Audit For the Fiscal Year Ended June 30, 1992

State Compensation Mutual Insurance Fund

This report contains six recommendations. Major issues addressed in the report include:

- ▶ Increasing audits of employer payroll.
- ▶ Implementing managed care.
- ▶ Financing past claims liabilities.

STATE DOCUMENTS COLLECTION

MAY 11 1993

MONTANA STATE LIBRARY
1515 E. 6th AVE.
HELENA, MONTANA 59620

PLEASE RETURN

Direct comments/inquiries to:
Office of the Legislative Auditor
Room 135, State Capitol
Helena, Montana 59620



FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Office of the Legislative Auditor to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations which could have a significant financial impact. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

The Single Audit Act of 1984 and OMB Circular A-128 require the auditor to issue certain financial, internal control, and compliance reports regarding the state's federal financial assistance programs, including all findings of noncompliance and questioned costs. This individual agency audit report is not intended to comply with the Single Audit Act of 1984 or OMB Circular A-128 and is therefore not intended for distribution to federal grantor agencies. The Office of the Legislative Auditor issues a statewide biennial Single Audit Report which complies with the reporting requirements listed above. The Single Audit Report for the two fiscal years ended June 30, 1991 has been issued. Copies of the Single Audit Report can be obtained by contacting:

Office of the Legislative Auditor
Room 135, State Capitol
Helena, MT 59620

MEMBERS OF THE LEGISLATIVE AUDIT COMMITTEE

Senator Greg Jergeson, Chairman
Senator Eve Franklin
Senator Lorents Grosfield
Senator Tom Keating

Representative John Cobb, Vice Chairman
Representative Larry Grinde
Representative Mike Kadas
Representative Robert Pavlovich



LEGISLATIVE AUDITOR:
SCOTT A. SEACAT

LEGAL COUNSEL:
JOHN W. NORTHEY

STATE OF MONTANA

Office of the Legislative Auditor

STATE CAPITOL
HELENA, MONTANA 59620
406/444-3122

January 1993

DEPUTY LEGISLATIVE AUDITORS:

MARY BRYSON
Operations and EDP Audit

JAMES GILLET
Financial-Compliance Audit

JIM PELLEGRINI
Performance Audit

To the Legislative Audit Committee
of the Montana State Legislature:

This is our financial-compliance audit report on the State Compensation Mutual Insurance Fund, Department of Administration, for fiscal year 1991-92. We performed this annual audit of the state fund in compliance with section 39-71-2361, MCA. The report contains recommendations concerning state fund operations and compliance with state laws and policies.

The written responses to audit recommendations are included at the end of the audit report. We thank the state fund president and his staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Scott A. Seacat", written over a horizontal line.

Scott A. Seacat
Legislative Auditor

Digitized by the Internet Archive
in 2011 with funding from
Montana State Library

<http://www.archive.org/details/statecompensatio1992mont>

Office of the Legislative Auditor

Financial-Compliance Audit

For the Fiscal Year Ended June 30, 1992

State Compensation Mutual Insurance Fund

Members of the audit staff involved in this audit were: Mark C. Barry,
John Fine, Glenn Jorgenson, D.J. Kimball, and Lorry Parriman.

Table of Contents

	List of Tables	ii
	Appointed and Administrative Officials	iii
	Summary of Recommendations	v
Introduction	Introduction	1
	Actuarial Soundness	2
	Financing Past Claims Liability	3
Prior Audit Recommendations	Prior Audit Recommendations	5
Findings and Recommendations	Employer Payroll Report Reviews	6
	Managed Care	7
	Benefits and Wage Loss	9
	Accounting Issues	11
	Recording Revenue	11
	Expenditure Accruals	12
	Electronic Data Processing Disaster Recovery	12
Disclosure Issue	Administrative Cost Allocation	14
Independent Auditor's Report & Agency Financial Statements	Summary of Independent Auditor's Report	A-2
	Independent Auditor's Report	A-3
	Balance Sheet as of June 30, 1992	A-4
	Statement of Revenues, Expenses, and Changes in Retained Earnings for the Fiscal Year Ended June 30, 1992	A-5
	Statement of Cash Flows for the Fiscal Year Ended June 30, 1992	A-6
	Notes to the Financial Statements	A-9
Agency Response	State Compensation Mutual Insurance Fund	B-3

List of Tables

<u>Table 1</u>	Premium Revenue Increase	3
<u>Table 2</u>	Projected Claims Costs for Fiscal Year 1990-91 Accidents (in thousands)	8

Appointed and Administrative Officials

State Compensation Mutual Insurance Fund Board of Directors and Executive Officers

Board Members

Term

James T. Harrison, Chairman	Helena	April 1993
Les Hirsch	Miles City	April 1995
Robert Holman	Kalispell	April 1995
Robert S. Short	Great Falls	April 1993
Clyde B. Smith	Kalispell	April 1993

Patrick Sweeney, President

James Murphy, Executive Vice President

John King, Vice President, Underwriting Department

Don MacMillan, Vice President, Benefits Department

Carla Smith, Vice President, Administrative and Finance
Department

Nancy Butler, General Counsel

Summary of Recommendations

This listing below serves as a means of summarizing the recommendations contained in the report, the state fund's response thereto, and a reference to the supporting comments.

<u>Recommendation #1</u>	We recommend the state fund increase review and audit of insured employers' payroll.	7
	<u>Agency Response:</u> Concur. See page B-4.	
<u>Recommendation #2</u>	We recommend the state fund:	
	A. Seek legislation to allow implementation of a managed care program.	
	<u>Agency Response:</u> Concur. See page B-4.	
	B. Investigate whether implementing a managed care program would help reduce medical costs.	9
	<u>Agency Response:</u> Concur. See page B-4.	
<u>Recommendation #3</u>	We recommend state fund limit payment of temporary total compensation benefits to claimants with total wage loss.	10
	<u>Agency Response:</u> Concur. See page B-4.	
<u>Recommendation #4</u>	We recommend state fund record:	
	A. Revenue in accordance with state accounting policy.	
	<u>Agency Response:</u> Concur. See page B-5.	
	B. Accounts receivable at the net realizable value by establishing an allowance for uncollectible accounts.	11
	<u>Agency Response:</u> Concur. See page B-5.	
<u>Recommendation #5</u>	We recommend the state fund establish procedures to record expenditures in the period incurred in accordance with state accounting policy.	12
	<u>Agency Response:</u> Do Not Concur. See page B-5.	

Summary of Recommendations

Recommendation #6

We recommend the state fund document a formal disaster recovery plan to comply with state law. 13

Agency Response: Concur. See page B-5.

Introduction

Introduction

The State Compensation Mutual Insurance Fund (state fund) was established by the 1989 Legislature to administer the state operated workers' compensation plan. Under state law, the Governor appoints five directors to set policy for the state fund. These directors hire a president to manage state fund operations. The state fund is attached to the Department of Administration for administrative purposes only. At June 30, 1992, the state fund had 222.5 authorized FTE. We performed a financial-compliance audit of the state fund for the fiscal year ended June 30, 1992 in accordance with section 39-71-2361, MCA. The objectives of the audit were to:

1. Determine state fund compliance with applicable laws and regulations.
2. Make recommendations for improvements in the management and internal accounting controls of the state fund.
3. Determine if the financial statements present fairly the financial position, results of operations, and cash flows of the state fund for the fiscal year ended June 30, 1992.
4. Determine the implementation status of prior audit recommendations.

This report contains six recommendations to state fund management. These recommendations address areas where state fund operations and compliance with laws and regulations can be improved. Other areas of concern deemed not to have a significant effect on the successful operations of the state fund are not specifically included in the report, but have been discussed with management.

In accordance with section 5-13-307, MCA, we analyzed and disclosed, if significant, the costs of implementing the recommendations made in this report.

Introduction

Actuarial Soundness

Section 39-71-2352, MCA, separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund). Premium rates are to be set to cover actuarially estimated costs incurred on or after July 1, 1990. Premium revenue will no longer be used to cover the liability and funding deficiency of claims incurred prior to that date. As a result, the term "actuarially sound" applies only to the New Fund for claims incurred on or after July 1, 1990. To be "actuarially sound" state fund management must set New Fund rates at a level sufficient to recover present and future costs of claims incurred during the period the rates are in effect.

State law directs state fund management to:

"make every effort to adequately predict future costs. When the costs of a factor influencing rates are unclear and difficult to predict, the state fund shall use a prediction calculated to be more than likely to cover those costs rather than less than likely to cover those costs."

We reviewed the assumptions and analysis of the actuary supporting the recommended 20 percent premium revenue increase for fiscal year 1992-93. We found the analysis used predictions calculated to be more than likely to cover New Fund costs for the period.

The estimated claims liability at June 30, 1992, determined by the state fund actuary, indicated the New Fund had a deficit of \$42.2 million. The actuarial analysis attributed the apparent increase in the claims liability to two factors:

- Costs associated with claims will continue over longer time periods.
- Cost reductions anticipated as a result of changes in the benefit laws enacted in 1987 and 1991 have not been confirmed by paid claims data.

The actuary said the cost reductions expected from changes in benefit laws could occur, but paid claims from accidents do not yet show a trend toward lower benefit levels. The actuary also cautioned the Board of Directors against attempting to recover

the deficit in one premium revenue increase. According to the actuary, the claims liability valuation is a volatile estimate which may overstate or understate the liability as of a given date.

The Board of Directors responded to the premium revenue shortfall indicated in last year's reserve report with an interim premium revenue increase of 11 percent, effective January 1, 1992. At the November 5, 1992 board meeting, the directors approved a premium revenue increase of 5 percent, effective January 1, 1993. The following table summarizes the last four premium revenue increases approved by the board.

Table 1	
<u>Premium Revenue Increase</u>	
<u>Effective Date</u>	<u>Percentage Increase</u>
July 1, 1991	15.7
January 1, 1992	11.0
July 1, 1992	20.0
January 1, 1993	5.0
Source:	Compiled by the Office of the Legislative Auditor

The cumulative effect of these increases is a premium revenue increase of 62 percent since July 1, 1991. The latest increase is projected to raise an additional \$3.5 million in revenue in the last two quarters of fiscal year 1992-93.

Financing Past Claims Liability

At June 30, 1992, the state fund's actuary valued the remaining liability associated with claims incurred prior to July 1, 1990 at \$406,718,552. During fiscal year 1991-92, state fund paid claims and administrative costs of \$67,396,170 and \$3,253,254, respectively, related to Old Fund accidents.

In August of 1991, the Board of Investments issued bonds totalling \$142,095,000. The bond proceeds were pledged to meet Old Fund claim costs. In addition, the Old Fund repaid loan principal totalling \$39,000,000 to the New Fund. Bond payments will be financed with revenues from the .28 percent tax on all payroll covered by workers' compensation insurance.

Introduction

Section 39-71-2355, MCA, restricts the amount of bonds or New Fund loans that the Board of Investments may provide to the Old Fund. The section states, ". . . the board of investments may not give the state fund loan proceeds or issue workers' compensation bonds unless the aggregate amount of outstanding and proposed loans and bonds can be serviced with no more than 90% of the amount of tax revenue that the department of revenue estimates will be raised by the tax imposed under section 39-71-2503, MCA, during the remainder of the then current fiscal year and during each succeeding fiscal year through the end of the fiscal year in which the last then outstanding or proposed loan or bond will be repaid or retired." Thus, the Board of Investments may not issue additional bonds or approve loans from the New Fund to the Old Fund unless the tax revenue is sufficient to make the required repayments.

Based on projected Old Fund cash flows prepared by the state fund management, payroll tax bond proceeds will cover Old Fund costs until January 1993. The Board of Investments has authorized the New Fund to lend up to \$32.2 million to the Old Fund to cover its obligations through June 30, 1993. Additional financing sources will be required to cover Old Fund costs after that date.

Prior Audit Recommendations

Prior Audit Recommendations

As part of our audit, we reviewed the implementation status of recommendations in the prior state fund audit for the fiscal year ended June 30, 1991. Our report included four recommendations. Three recommendations are still applicable to the state fund and one recommendation, concerning payroll tax administration costs, is no longer applicable to the state fund. In addition, we reviewed the status of two recommendations made in our report of the Department of Labor and Industry and the State Compensation Mutual Insurance Fund for the two fiscal years ended June 30, 1990. These recommendations address concerns over a disaster recovery plan and system security officer functions.

Of the five recommendations reviewed which are still applicable, state fund implemented two of the recommendations. The three recommendations not implemented involve allocating administrative costs to the Old Fund in accordance with state law (page 14), limiting payments of compensation benefits to claimants with total wage loss (page 9), and disaster recovery planning (page 12).

Findings and Recommendations

Employer Payroll Report Reviews

The Underwriting Department of the state fund has procedures in place for performing reviews of payroll reports to ensure employer payroll information and employee classifications are correctly reported. According to state fund officials, 90 percent of the reviews performed are the result of referrals from the state fund's policy services employees, claims examiners, or other state agencies, such as the Department of Labor and Industry. Employers may also request a review of their records. The other 10 percent are chosen based on premium paid and payroll classification codes.

The audit bureau of the Underwriting Department performs desk reviews of information provided by the employer or makes on-site inspections of the employer's workplace and records. Desk reviews entail obtaining information from the employers and comparing it to the information reported on the payroll reports for reasonableness. On-site inspections consist of field representatives performing a financial review of the employer's payroll to determine if the employer is paying the proper premium and reporting the proper class codes for employees.

In fiscal year 1991-92, the audit bureau performed desk reviews and/or field audits for 1,348 insured employers. The examination covered \$10,034,103 of premiums or approximately 8 percent of total premium revenue recorded for the fiscal year. According to state fund records, more than 50 percent of the desk reviews and field audits performed resulted in either a credit to the employer or additional premium due for a net additional premium due of approximately \$744,582. The audit bureau, with 13 FTE, expended \$452,672 resulting in approximately \$291,000 of additional premiums in excess of audit bureau costs.

We contacted managers at state insurance funds in several surrounding states to determine the degree other states review their employers' payroll. These states audit between 15 percent and 30 percent of their insured employers. The states contacted do not attempt to audit payroll of all employers, but rather select employers based on referrals, requests, amount of premium, and

Findings and Recommendations

classification codes similar to selection procedures used by the state fund. According to the managers, their state insurance funds experience additional premium revenue of \$1.5 to \$4 million a year from audit reviews.

State fund officials said an increase in review of insured employers' payroll from the present 8 percent level would probably produce additional premium revenue and provide more impetus to employers to properly classify and report payroll. The state fund submitted a budget modification to the Office of Budget and Program Planning (OBPP), for eight additional FTE during fiscal years 1993-94 and 1994-95 at an estimated additional cost of \$450,000 and \$599,000 each year, respectively. OBPP turned down the request, stating only emergency modifications would be considered until recommendations came from the Governor's Task Force on Workers' Compensation. In addition to potential additional premium revenue, an increase in reviews of insured employers' records would encourage employer's to properly classify and report their payroll.

Recommendation #1

We recommend the state fund increase review and audit of insured employers' payroll.

Managed Care

At June 30, 1992, the estimated unpaid claims determined by the state fund actuary amounted to \$406,718,552 for the Old Fund and a net present value of \$211,994,569 for the New Fund. We compared the state fund actuary's reports as of June 30, 1991 and as of June 30, 1992. We analyzed the change in estimated claims costs for accidents occurring in fiscal year 1990-91 in these reports. The reports indicate the medical portion of claims cost increased 37 percent while the indemnity portion increased 22 percent. The following table shows the larger growth in medical costs.

Findings and Recommendations

Table 2				
Projected Claims Costs for Fiscal Year 1990-91 Accidents (in thousands)				
Type of Cost Estimate	State Fund Actuary Report		Increase	% Increase
	As of 06-30-91	As of 06-30-92		
Indemnity	\$ 92,237	\$112,500	\$20,263	22%
Medical	\$ 38,356	\$ 52,500	\$14,144	37%
Total	\$130,593	\$165,000	\$34,407	26%
Source: Compiled by the Legislative Auditor using projected claims costs calculated by the state funds's actuary.				

Section 39-71-704, MCA, requires the state fund to cover all reasonable and necessary medical procedures performed by licensed practitioners, which are the result of a compensable industrial injury or occupational disease. In addition, section 33-22-111, MCA, grants the injured employee the right to choose the attending physician. An attending physician may order diagnostic procedures, such as x-rays, prescribe medication, and begin treatment procedures. If the injured worker does not respond to treatment, the attending physician could refer the claimant to other physicians, specialists or surgeons, who may order additional diagnostic procedures.

By state law all services performed, whether or not they are duplicate services, are determined reasonable and necessary and covered by the workers' compensation insurer. In addition, while the claimant is referred to other physicians, the claimant continues to receive compensation benefits as well as medical benefits. Since the injured employee can choose the attending physician and the insurer must pay for reasonable and necessary medical procedures as determined by the selected physicians, state fund cannot initiate managed care programs.

Under a managed care program, an administering organization refers an injured worker to appropriate services based on the type of injury. The organization is experienced in handling care for injuries and could direct the injured worker to appropriate treatment services. A managed care program reduces costs by

Findings and Recommendations

improving timeliness and coordination of services, monitors duplicate services such as x-rays, guides an injured worker to the most appropriate services, determines the maximum medical improvement, and provides uniform determination of disability and impairment percentages. State fund is not liable for medical costs incurred beyond the claimants maximum medical improvement, and timely determination of maximum healing could lower medical costs. The fund should seek legislation allowing them to implement managed care alternatives to control the rising medical costs associated with workers compensation claims.

We believe a managed care program could help control state fund medical costs in addition to providing reasonable and necessary medical services to injured workers. The Department of Administration has implemented managed care for the state employee health plan. In fiscal year 1991-92, the department calculated the savings attributed to case management to be 3.26 times the costs of the case management program. The state fund should analyze managed care to determine if it will help reduce medical costs.

Recommendation #2

We recommend the state fund:

- A. Seek legislation to allow implementation of a managed care program.**
- B. Investigate whether implementing a managed care program would help reduce medical costs.**

Benefits and Wage Loss

In our prior audit report, we noted the state fund paid temporary total benefits for worker's compensation to claimants receiving sick and annual leave benefits. State fund paid \$101,436 on 27 accident claims by Department of Transportation employees for accidents occurring in fiscal year 1990-91. The department

Findings and Recommendations

allowed employees who were injured and receiving worker's compensation payments for loss of wages to also receive sick or annual leave. Section 39-71-701(1), MCA, limits eligibility for temporary total disability benefits to workers who suffer a total loss of wages as a result of an injury. Section 39-71-123, MCA, defines as wages. . . "remuneration at the regular hourly rate for overtime work, holidays, vacations, and sickness periods." A recent attorney general opinion interpreted state law to mean a claimant who receives sick or annual leave pay is not entitled to temporary total benefits. By paying temporary total benefits to the above claimants, state fund paid benefits in excess of the limits set by state law.

According to a state fund official, claims department personnel inform employers and claimants that sick leave pay should not be paid while worker's compensation benefits are being received. However, state fund has not yet changed procedures regarding vacation pay in response to the attorney general's interpretation of state law, the official said. On occasion, an employer will request claims examiners to calculate the amount the employer should pay an employee to bring compensation, worker's compensation benefits plus vacation pay, to the employee's salary level, the official said.

State fund should inform employers insured by the state fund that claimants are not allowed to receive sick or annual leave concurrently with compensation benefits for wage loss. The state fund should also implement procedures to monitor payments to claimants to ensure wage loss benefits are not supplemented with sick or annual leave.

Recommendation #3

We recommend state fund limit payment of temporary total compensation benefits to claimants with total wage loss.

Findings and Recommendations

Accounting Issues

Section 17-2-102, MCA, requires state agencies to report financial activity in the state's accounting records in accordance with generally accepted accounting principles. In the following two sections, we discuss concerns with the state fund's compliance with this law. Our recommendations address procedures state fund personnel should perform at the end of each fiscal year to report financial activity in accordance with state law.

Recording Revenue

According to state accounting policy, the state fund should record revenue when it is earned and is measurable. In fiscal year 1991-92, the state fund earned, but did not record, \$2,079,709 of premium revenue on the state's accounting records. According to state fund personnel, these premiums have been disputed by policyholders and are under review, in court proceedings, or bankruptcy proceedings. The accounts are placed in administrative review so the policyholder does not receive a bill until the dispute is resolved.

In addition, a state fund official said it is not certain that premium revenues under administrative review will actually be collected. Since the revenue has been earned and is measurable, the state fund should record the revenue and the related accounts receivable. The estimated amount to be realized through collection can be reflected by recording an allowance for doubtful accounts.

Recommendation #4

We recommend state fund record:

- A. Revenue in accordance with state accounting policy.**
- B. Accounts receivable at the net realizable value by establishing an allowance for uncollectible accounts.**

Findings and Recommendations

Expenditure Accruals

We determined the state fund did not record expenditures of \$180,250 related to lump sum settlement agreements reached prior to the end of fiscal year 1991-92. Under state accounting policy, expenditures of the state fund should be recorded in the period they are incurred and measurable. Since the state fund and the claimant reached an agreement on the amount prior to the end of the fiscal year, the expenditure for the settlement should have been recorded in fiscal year 1991-92.

State law requires the state fund to submit lump sum agreements to the Department of Labor and Industry for their review and concurrence. State fund personnel stated the settlements are recorded when they are approved by the Department of Labor and submitted to the administrative and finance department for payment. According to state fund officials, the Department of Labor and Industry rarely questions the settlements. We believe the state fund should record expenditures at the time the settlements are agreed to by the claimant.

Recommendation #5

We recommend the state fund establish procedures to record expenditures in the period incurred in accordance with state accounting policy.

Electronic Data Processing Disaster Recovery

In our audit of the Department of Labor and Industry for the two fiscal years ended June 30, 1990, we recommended the state fund develop a disaster recovery plan for its minicomputer. The state fund has not developed a plan. Section 2-15-114, MCA, requires each department to have appropriate safeguards to reduce or recover from identified threats to data and information technology.

The critical application on the minicomputer is benefit payments for compensation and medical claims. The state fund has an

Findings and Recommendations

informal arrangement with the Commissioner of Higher Education to run applications in case of hardware failure. However, the state fund has not documented responsibilities of data processing personnel in the event of an emergency where the state fund's data processing system is damaged. Responsibilities which should be assigned include obtaining backup programs and files from storage, and staffing to run applications at the alternative site.

Data processing personnel said they have not documented disaster recovery because they are waiting for guidelines from the Department of Administration, Information Services Division for documentation requirements. Those guidelines have not been established. The state fund also anticipates seeking authority to move the benefits applications to a local area network based system and discontinue use of its minicomputer. At a minimum, the state fund should document personnel responsibilities so its staff are aware of their roles in emergency situations where the data processing system is damaged.

Recommendation #6

We recommend the state fund document a formal disaster recovery plan to comply with state law.

Disclosure Issue

Administrative Cost Allocation

Section 39-71-2352, MCA, requires the fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund to \$3 million. In fiscal year 1991-92, the Old Fund administrative costs exceeded \$3 million by \$253,254. The fund recorded only \$3 million in administrative costs in the Old Fund.

The purpose of the provisions in state law is to clearly separate the funding sources of the Old and New Funds and relieve current premium payers of costs associated with the unfunded liability of the Old Fund. The state fund incurred Old Fund administrative costs in excess of \$3 million, but charged the excess to the New Fund. The law requires both the allocation of costs and the limitation of Old Fund costs to \$3 million per year.

In our previous audit report, we determined the fund established procedures to separate costs between the Old Fund and New Funds. We reported the fund had exceeded the \$3 million limit of administrative costs in the Old Fund. We recommended the fund allocate and limit administrative costs related to pre July 1, 1990 injuries or seek legislation to amend the limit. Since the legislature has not met for regular session since our last audit, the fund has not yet sought legislation. Therefore, we make no further recommendations on Old Fund administrative costs.

Independent Auditor's Report & Agency Financial Statements

Summary of Independent Auditor's Report

Summary of Independent Auditor's Report

The auditor's opinion issued on the financial statements contained in this report is intended to convey to the reader the degree of reliance which can be placed on the amounts presented. The reader may rely on the fairness of the amounts on the statements presented on pages A-4 through A-15 when analyzing the financial activity of the State Compensation Mutual Insurance Fund.

STATE OF MONTANA

Office of the Legislative Auditor

STATE CAPITOL
HELENA, MONTANA 59620
406/444-3122



LEGISLATIVE AUDITOR:
SCOTT A. SEACAT

LEGAL COUNSEL:
JOHN W. NORTHEY

INDEPENDENT AUDITOR'S REPORT

DEPUTY LEGISLATIVE AUDITORS:

MARY BRYSON
Operations and EDP Audit

JAMES GILLETT
Financial-Compliance Audit

JIM PELLEGRINI
Performance Audit

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the financial statements of the State Compensation Mutual Insurance Fund (state fund), Old and New Funds, as of June 30, 1992, and for the fiscal year then ended as shown on pages A-4 through A-15. The information contained in these financial statements is the responsibility of state fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the state fund, as of June 30, 1992, and the results of operations and the cash flows of its Enterprise Funds for the fiscal year then ended in conformity with generally accepted accounting principles.

As discussed in note 12, the Old Fund has insufficient means to meet its incurred claims costs under the current law.

Respectfully submitted,

A handwritten signature in cursive script, reading "James Gillett".

James Gillett, CPA
Deputy Legislative Auditor

November 5, 1992

STATE COMPENSATION MUTUAL INSURANCE FUND
BALANCE SHEET - ENTERPRISE FUND
JUNE 30, 1992
(in thousands)

	<u>New Fund</u>	<u>Old Fund</u>
ASSETS:		
Cash/Cash Equivalents (note 3)	\$ 85,120	\$ 8,361
Receivables (Net) (note 1)	32,654	475
Due from Other Funds	2,108	2,129
Inventories	59	
Long Term Loans/Notes Receivable		2
Investments (note 3)	58,415	33,706
Equipment	1,237	
Accumulated Depreciation	(326)	
Intangible Assets	37	
Deferred Charges		3,861
Other Assets	<u>10,514</u>	
TOTAL ASSETS	<u>\$189,818</u>	<u>\$ 48,534</u>
LIABILITIES/FUND EQUITY:		
Liabilities:		
Accounts Payable	165	843
Due to Other Funds	753	1,813
Bonds/Notes Payable (Net) (note 5)		138,244
Property Held in Trust (note 1)	18,710	
Compensated Absences Payable (note 8)	433	
Estimated Insurance Claims (note 4)	<u>211,995</u>	<u>406,719</u>
Total Liabilities	<u>232,056</u>	<u>547,619</u>
Fund Equity:		
Contributed Capital (note 1)	12,011	
Retained Earnings:		
Unreserved	<u>(54,249)</u>	<u>(499,085)</u>
Total Fund Equity	<u>(42,238)</u>	<u>(499,085)</u>
TOTAL LIABILITIES/FUND EQUITY	<u>\$189,818</u>	<u>\$ 48,534</u>

The notes are an integral part of the financial statements.

STATE COMPENSATION MUTUAL INSURANCE FUND
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS
ENTERPRISE FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 1992
 (in thousands)

	<u>New Fund</u>	<u>Old Fund</u>
OPERATING REVENUES:		
Charges for Services	\$ 37	
Investment Earnings	6,035	\$ 4,625
Contributions/Premiums	126,765	15
Other Operating Revenues	<u>28</u>	<u>19</u>
Net Operating Revenues	<u>132,865</u>	<u>4,659</u>
OPERATING EXPENSES:		
Personal Services	3,570	2,263
Contractual Services	1,481	723
Supplies/Materials	71	34
Expendable Materials	75	
Benefits	168,610	39,887
Depreciation	152	
Utilities/Rent	90	32
Communications	292	186
Travel	86	29
Repair/Maintenance	69	52
Interest Expense		9,569
Other Operating Expenses	<u>928</u>	<u>22</u>
Net Operating Expenses (note 6)	<u>175,424</u>	<u>52,797</u>
Operating Income (Loss)	<u>(42,559)</u>	<u>(48,138)</u>
NONOPERATING REVENUES (EXPENSES):		
Gain (Loss) on Sale of Fixed Assets	<u>3</u>	
Total Nonoperating Revenues (Expenses)	<u>3</u>	
Income (Loss) Before Operating Transfers	(42,556)	(48,138)
Operating Transfers In (note 7)		12,013
Operating Transfers Out	<u>(2,384)</u>	<u>(665)</u>
Net Income (Loss)	<u>(44,940)</u>	<u>(36,790)</u>
RETAINED EARNINGS - JULY 1 -		
As Previously Reported	(9,309)	(461,560)
Prior Period Adjustments		<u>(735)</u>
RETAINED EARNINGS - JULY 1 - As Restated	<u>(9,309)</u>	<u>(462,295)</u>
RETAINED EARNINGS - JUNE 30	<u>\$(54,249)</u>	<u>\$(499,085)</u>

The notes are an integral part of the financial statements.

STATE COMPENSATION MUTUAL INSURANCE FUND
STATEMENT OF CASH FLOWS - ENTERPRISE FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 1992
(in thousands)

	<u>New Fund</u>	<u>Old Fund</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts for Sales and Services	\$123,873	\$ 411
Payments to Suppliers for Goods and Services	(4,429)	(926)
Payments to Employees	(3,916)	(1,812)
Cash Payments for Claims	(47,885)	(66,348)
Collection of Notes Receivable	24	111
Other Operating Revenues	<u>65</u>	<u>19</u>
Net Cash Provided by (Used for) Operating Activities	<u>67,732</u>	<u>(68,545)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Payment of Principle and Interest on Bonds and Notes		(11,021)
Payment of Bond Issuance Costs		(2,395)
Proceeds from Issuance of Bonds and Notes (note 5)		145,427
Transfers to Other Funds	(2,371)	(665)
Transfers from Other Funds		13,211
Cash Payments for Loans	(7,000)	(39,000)
Collections for Principal and Interest on Loans	<u>39,306</u>	<u> </u>
Net Cash Provided by (Used for) Noncapital Financing Activities	<u>29,935</u>	<u>105,557</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:		
Acquisition of Fixed Assets	(167)	
Proceeds from Sale of Fixed Assets	<u>3</u>	
Net Cash Used for Capital and Related Financing Activities	<u>(164)</u>	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchasing of Investments	(65,569)	(66,259)
Proceeds from Sales or Maturities of Investments	10,138	32,483
Interest and Dividends on Investments	<u>5,974</u>	<u>4,452</u>
Net Cash Provided by (Used for) Investing Activities	<u>(49,457)</u>	<u>(29,324)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	48,046	7,688
Cash and Cash Equivalents, July 1	<u>37,074</u>	<u>673</u>
Cash and Cash Equivalents, June 30	<u>\$ 85,120</u>	<u>\$ 8,361</u>

(Continued on page A-7)

STATE COMPENSATION MUTUAL INSURANCE FUND
STATEMENT OF CASH FLOWS - ENTERPRISE FUND
FOR THE FISCAL YEAR ENDED JUNE 30, 1992
(in thousands)

(continued from page A-6)

	<u>New Fund</u>	<u>Old Fund</u>
RECONCILIATION OF OPERATING INCOME TO NET		
CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating Income (Loss)	\$(42,559)	\$(48,138)
ADJUSTMENTS TO RECONCILE OPERATING INCOME		
TO NET CASH PROVIDED BY (USED FOR)		
OPERATING ACTIVITIES:		
Depreciation	152	
Interest on Investments	(6,035)	(4,624)
Interest Expense		9,569
Change in Assets and Liabilities:		
Decr (Incr) in Accounts Receivable	(3,802)	(354)
Decr (Incr) in Due from Other Funds	(1,287)	4
Decr (Incr) in Long-Term Loans/Notes Receivable		2
Decr (Incr) in Other Assets	(1,018)	
Incr (Decr) in Accounts Payable	(208)	(2)
Incr (Decr) in Due to Other Funds	86	1,733
Incr (Decr) in Property Held in Trust	1,595	
Incr (Decr) in Compensated Absences Payable	38	
Incr (Decr) in Estimated Claims	<u>120,770</u>	<u>(26,735)</u>
Net Cash Provided by (Used for)		
Operating Activities	<u>\$ 67,732</u>	<u>\$ (68,545)</u>

The notes are an integral part of the financial statements.

Notes to the Financial Statements

For the Fiscal Year Ended June 30, 1992

1. **Summary of Significant Accounting Policies**

The State Compensation Mutual Insurance Fund (state fund) records activity related to its workers' compensation insurance operations in the Enterprise Fund type. The Enterprise Funds of the state fund are part of, but do not comprise, the entire Enterprise Fund of the state of Montana. These financial statements reflect the financial position and results of operations and cash flows of the state fund, not the state of Montana.

Basis of Accounting

The state fund uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations.

Under the accrual basis, the state fund records revenues in the accounting period earned, if measurable; they record expenses in the period incurred, if measurable.

Fixed assets are valued at actual or estimated historical cost less accumulated depreciation.

Receivables in the New Fund include accrued premiums from the fourth quarter of fiscal year 1991-92.

Property Held in Trust consists of required policy holder deposits which secure payment of premiums.

Contributed Capital accounts for assets transferred from the Old Fund to provide the initial capitalization of the New Fund as authorized by state law and equipment transferred from the Department of Labor and Industry upon decentralization of the audit bureau.

Fund Equity consists of contributed capital and the net excess or deficit of assets over liabilities.

Basis of Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. State fund insurance operations are classified in the Enterprise Fund type.

Notes to the Financial Statements

The Enterprise Fund type is used to account for operations (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; or (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred, or net income is appropriate.

2. **Old Fund and New Fund**

Chapter 4, Special Session May 1990, separated the liability of the state workers' compensation insurance fund based on whether the liability arises from claims for injuries resulting from accidents that occurred before or after July 1, 1990. The legislation establishes separate funding and accounts for claims occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990 referred to as the New Fund.

3. **Cash Equivalents and Investments**

The state fund invests moneys with the Board of Investments. Investments in the Short-Term Investment Pool (STIP) are considered cash equivalents under the state accounting policy. All investments of the state fund, except securities on loan, are classified in risk category 1, which includes investments that are insured, registered, or uninsured unregistered securities held by the state or its agent in the state's name. The New Fund and Old Fund investment portfolios includes \$6,741,071 and \$1,428,571, respectively, in securities on loan. Securities on loan are classified as risk category 2. Category 2 includes uninsured and unregistered investments for which the securities are held for the Board of Investments or its agent in the state's name. The market value of the New Fund and Old Fund portfolios were \$58,415,171 and \$33,705,507, respectively, at June 30, 1992.

4. **Risk Management- Public Entity Risk Pools**

The Old and New Funds are public entity risk pools. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claim adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other socio-economic factors. By statute, these funds cannot invest in common stock.

Notes to the Financial Statements

Investments are recorded at amortized cost, where applicable. Premiums and discounts are amortized using the straight-line method over the life of the securities. An average life of eight years is used for amortization of mortgage discounts.

New Fund -- Liability coverage to employers for injured employees that are insured under the Worker's Compensation and Occupational Disease Acts of Montana and workers' compensation claims occurring on or after July 1, 1990, are reported in the New Fund. The New Fund must insure any employer who desires coverage. At fiscal year-end, approximately 26,682 employers were insured with the New Fund. Anticipated investment income is considered for computing a premium deficiency and employers must pay premiums to the state fund within specified timeframes.

An actuarial study prepared for the New Fund as of June 30, 1992 estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience.

At June 30, 1992, \$291,401,535 of unpaid claims and claim adjustment expenses are presented at their net present value of \$211,994,569. These claims are discounted at an annual rate of 7 percent. The New Fund uses reinsurance agreements to reduce its exposure to large losses. Reinsurance permits recovery of a portion of losses from the reinsurers, although it does not discharge the primary liability of the fund as direct insurer. The New Fund did not deduct any claim liabilities related to potential reinsurance recoveries. When the New Fund purchases annuity contracts, the claim is settled in full and on a final basis and all liability of the New Fund is terminated.

Old Fund -- The liability and payment of workers' compensation claims for incidents occurring before July 1, 1990, are reported in the Old Fund. There is no premium income; however, funding for claims payments is provided by a .28 percent payroll tax on all Montana employers. The 1991 Legislature authorized issuance of revenue bonds to provide

Notes to the Financial Statements

necessary operating cash to pay the liabilities of pre-July 1, 1990, accidents. The employer payroll tax will provide funding for bond payments. An actuarial study prepared for the Old Fund as of June 30, 1992, was used to estimate liabilities and the ultimate cost of settling claims that have been reported but not settled and claims that have been incurred but not reported. At June 30, 1992, \$406,718,552 of unpaid claims and claim adjustment expenses are presented at face value. Total Old Fund deficit is \$499,085,000. This fund does not discount estimated claims liabilities.

5. Payroll Tax Bonds (Workers' Compensation Program)

The Board of Investments of the state of Montana issued \$142,095,000 of bonds in August 1991 for the purpose of funding the state's liability and costs in administering and paying claims for injuries resulting from accidents, prior to July 1, 1990, that are subject to the Montana Workers' Compensation Act and the Occupational Disease Act of Montana. The bonds bear interest at rates from 4.9 to 6.875 percent, and are limited obligations of the state of Montana payable solely from and secured by certain payroll tax revenues collected by the Department of Revenue of the state of Montana. Amounts of bond debt outstanding at June 30, 1992 are shown below in thousands.

Bonds Outstanding <u>June 30, 1992</u>	<u>Discount</u>	Net Bond Debt <u>June 30, 1992</u>
\$140,245	\$2,001	\$138,244

Debt service requirements for principal and interest are as follows (in thousands):

<u>Fiscal Year</u>	Debt Service <u>Payments</u>
1992-93	\$11,320
1993-94	\$11,319
1994-95	\$11,318
1995-96	\$11,321
1996-97	\$11,318
1997-98+	\$260,358
Totals	\$316,954

Notes to the Financial Statements

- 6. Administrative Cost Allocation**
- Section 39-71-2352, MCA, requires the state fund to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (New Fund). The law also limits annual administrative costs of claims associated with the Old Fund. The state fund incurred Old Fund administrative costs of \$253,254 in excess of the limit, and charged the excess to the New Fund.
- 7. Transfers**
- The state fund received net transfers of payroll tax moneys of \$12,013,000 from the Special Revenue Fund payroll tax entity to its Old Fund in fiscal year 1991-92. The payroll tax revenue is recorded in the Special Revenue Fund as required by state law.
- 8. Compensated Absences**
- Employees at the state fund accumulate both annual and sick leave. The state fund pays employees for 100 percent of unused annual leave, 25 percent of unused sick leave. The fund pays 100 percent of unused compensatory leave credits upon termination to nonexempt employees. The state fund absorbs expenditures for termination pay in its annual operational costs. At June 30, 1992, the state fund had a leave liability of \$433,424.
- 9. Pension Plan**
- The state fund and its employees contribute to the Public Employees Retirement System (PERS), a cost sharing, multiple employer, defined benefit pension plan. Established in 1945 and governed by Title 19, Chapter 3, MCA, PERS participants are eligible to retire at age 60 with at least five years of service, at age 65 regardless of length of service or at 30 years of service regardless of age. A reduced retirement benefit may be taken with 25 years of service or at age 50 with a minimum of five years of service. Monthly retirement benefits are calculated by taking 1/56 times the years of service times the final average salary. Vesting occurs once membership service totals 5 years. State fund and its employees each were required to contribute 6.417 percent of annual compensation in fiscal year 1991-92.

Notes to the Financial Statements

As of June 30, 1992, 222.5 state fund employees were covered by PERS. State fund covered payroll was \$4,670,604 and PERS contributions were \$294,835 in fiscal year 1991-92.

Actuarial valuations are performed at PERS every two years. The latest valuation was performed as of July 1, 1992. In calculating the pension benefit obligation, the actuary assumed a return on investments of 8 percent, salary inflation increases of 6.5 percent and no change in post retirement benefits.

The "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure, which is the actuarial present value of credited projected benefits, is intended to help users assess the system's funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due and make comparisons among employers. The state fund is unable to determine the actuarial present value of credited projected benefits and net assets available for benefits since the information is available only on a total state basis, not agency basis.

The pension benefit obligation at June 30, 1992, for PERS as a whole was \$1,294,672,000. The system's net assets available for benefits at cost on June 30, 1992, were \$1,007,757,000 leaving an overall unfunded pension benefit obligation of \$286,915,000. The state fund's 1992 contribution represented approximately .4 percent of total June 30, 1992, contributions required of all participating entities. The state fund is not responsible for any state system unfunded liability.

Ten-year historical trend information showing the PERS progress in accumulating sufficient assets to pay benefits when due is presented in the system's June 30, 1992, annual financial report.

Notes to the Financial Statements

- 10. Building**
- The 1981 Legislature appropriated funds for the construction of a Workers' Compensation building. State fund expenses annual payments on the building in its operating budget. As of July 1, 1990, the state fund transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under the agreement, the state fund will pay all costs associated with the building, including utilities, debt service, janitorial services, and maintenance in lieu of paying rent.
- 11. Subsequent Events**
- On October 8, 1992, the Board of Investments authorized \$32.2 million in loans from the New Fund to the Old Fund to cover unfunded administrative and benefit obligations.
- 12. Old Fund Financing**
- Under section 39-71-2354, MCA, the Old Fund receives revenue from the payroll tax to pay the costs associated with claims incurred on or before June 30, 1990. The Board of Investments sold bonds secured by payroll tax revenue as described in note 5. The bond proceeds and payroll tax revenue in excess of the amount required to secure the bonds are insufficient to meet costs associated with Old Fund claims. Section 39-71-2355, MCA, restricts the amount of bonds or New Fund loans that may be provided to the Old Fund. Under this law, the Board of Investments may not give the state fund loan proceeds or issue bonds unless the aggregate amount of outstanding and proposed loans and bonds can be serviced with no more than 90 percent of the amount of payroll tax revenue per 39-71-2503, MCA, that the Department of Revenue estimates will be raised during the remainder of the then current fiscal year and during each succeeding fiscal year until the end of the fiscal year in which the last then outstanding or proposed loan or bond will be repaid or retired. As stated in note 11, Board of Investments has authorized the Old Fund to borrow \$32.2 million from the New Fund to cover its obligations through June 30, 1993. If the 1993 legislature does not approve funding, the Old Fund will be unable to meet its claims obligations beyond June 30, 1993.

Agency Response



STATE COMPENSATION MUTUAL INSURANCE FUND

P.O. BOX 4759

HELENA, MONTANA 59604-4759

GENERAL INFORMATION (406) 444-6500

January 8, 1993

Mr. Scott A. Seacat
Legislative Auditor
State Capitol Building
Helena, MT 59620

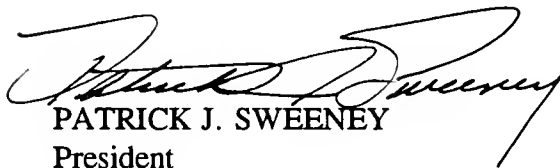
Dear Mr. Seacat:

Enclosed is our response to the recommendations in your audit of the State Compensation Mutual Insurance Fund.

We appreciate the cooperation of your staff in completing this audit and discussing your findings with us.

State Fund representatives will be happy to answer any further questions about the audit and our response.

Sincerely,



PATRICK J. SWEENEY
President

STATE COMPENSATION MUTUAL INSURANCE FUND

Response to Legislative Audit Recommendations

Recommendation #1

We recommend the state fund increase review and audit of insured employers' payroll.

Agency Response

Concur. We will continue to seek ways to improve our audit coverage such as we did by implementing desk audits. We have also requested additional staff to expand audit coverage and will explore the use of contracted audits.

Recommendation #2

- A. Seek legislation to allow implementation of a managed care program.
- B. Investigate whether implementing a managed care program would help reduce medical costs.

Agency Response

Concur. The State Fund staff is currently working with members of the Legislature to draft a bill regarding managed care. Managed care involves several areas relating to medical cost containment, and the State Fund will attempt to evaluate each of these areas if the legislation is enacted, with a view towards reducing medical costs and still maintaining adequate and proper treatment for the injured workers.

Recommendation #3

We recommend state fund limit payment of temporary total compensation benefits to claimants with total wage loss.

Agency Response

Concur. The State Fund will inform all its policyholders that claimants are not allowed to receive sick or annual leave concurrently with compensation benefits for wage loss.

Recommendation #4

We recommend state fund record:

- A. Revenue in accordance with state accounting policy.
- B. Accounts receivable at the net realizable value by establishing an allowance for uncollectible accounts.

Agency Response

Concur.

The State Fund will review accounts in administrative review at year end and will record the revenue set aside and an allowance for uncollectible accounts.

Recommendation #5

We recommend the state fund establish procedures to record expenditures in the period incurred in accordance with state accounting policy.

Agency Response

Do not concur. The State Fund does not believe an obligation for a lump sum settlement is incurred until the Department of Labor & Industry has approved the settlement in accordance with statutory requirements. Therefore, the State Fund will not record an expenditure for a lump sum settlement until the approval takes place.

Recommendation #6

We recommend the state fund document a formal disaster recovery plan to comply with state law.

Agency Response

Concur. The State Fund feels a complete and current disaster recovery plan is an important part of maintaining adequate data processing documentation. Such a plan will be developed as soon as state guidelines are completed. In the interim, the State Fund will develop a minimal plan outlining personnel responsibilities in the event of an emergency, as suggested in the audit report.

